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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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Federal Communications Commission
Office of Secretary

In the Matter of	)	
Implementation of the Telecommunications Act of 1996	)	CC Docket No. 96-150
Accounting Safeguards Under the Telecommunications Act of 1996	)	

PETITION FOR PARTIAL RECONSIDERATION OF THE AMERICAN PUBLIC COMMUNICATIONS COUNCIL

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February 20, 1997

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In the Matter of Implementation of the Telecommunications Act of 1996 Accounting Safeguards Under the Telecommunications Act of 1996	CC Docket No. 96-150

PETITION FOR PARTIAL RECONSIDERATION OF THE AMERICAN PUBLIC COMMUNICATIONS COUNCIL

The American Public Communications Council ("APCC") hereby petitions for partial reconsideration of the Commission's Report and Order, FCC 96-490, released in this proceeding on December 24, 1996. APCC requests reconsideration of the Commission's decision not to require the Bell companies to maintain separate books of account for their nonregulated payphone service activities and not to apply the affiliate transaction rule to asset transfers between the Bell companies' regulated operations and their nonregulated payphone operations. Report and Order, ¶ 100.

BACKGROUND

Section 276(b)(1)(B) of the Act requires the Commission to "discontinue . . . all intrastate and interstate payphone subsidies. . . ." 47 U.S.C. § 276(b)(1)(B). As discussed in the attached documents, the Senate-House Conference Committee's explanatory statement on Section 276 expressly stated that, in order to discontinue subsidies:

> The [Bell company] payphone operations will be transferred, at an appropriate valuation, from the regulated accounts associated with local exchange services to the [Bell company's] unregulated books.

H.R. Conf. Rep. No. 458, 104th Cong., 1st Sess. 158 (1996) ("Conference Report"). In CC Docket No. 96-128, APCC and other payphone associations requested the Commission to carry out this express statement of Congressional intent that Bell companies' payphone operations be transferred out of regulation at fair market value (including a "going concern" valuation of in-place payphone equipment and associated contracts and goodwill).

After completion of the comment cycle in the instant proceeding, the Commission released an order in the payphone proceeding in which it declined to require Bell companies to transfer their payphone operations at fair market value unless a Bell company voluntarily chooses to operate its payphone services through an affiliate. Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128, Notice of Proposed Rulemaking, 11 FCC Rcd 6716 (1996), Report and Order, FCC 96-388, released September 20, 1996 ("Payphone Order"), ¶¶ 161-71, Order on Reconsideration, FCC 96-439, released November 8, 1996 ("Payphone Reconsideration Order"), pets. for review pending, Illinois Public Telecommunication Ass'n v. FCC, (D.C. Cir., No. 96-1394). The

Commission stated it would not require a transfer at fair market value to unregulated books because such a transfer would be inconsistent with the Commission's existing accounting rules, and "we see no compelling argument to deviate from those well-settled rules at this time." Id., ¶169. The Commission noted that changes to the accounting rules were under consideration in this proceeding. Id., n. 576. On reconsideration, the Commission affirmed its decisions not to require a valuation and not to require transfer of the Bell companies payphone operations at fair market value to separate unregulated books. Payphone Reconsideration Order, ¶ 178.

Subsequently, the Commission released the Report and Order in this proceeding, in which it did not adopt APCC's proposal to apply the affiliate transaction rule to transactions between a local exchange carrier and nonregulated payphone operations that have not been placed in a separate affiliate. See APCC Comments at 8-10.

DISCUSSION

APCC has petitioned for review of the Commission's decisions in CC Docket No. 96-128 regarding transfer and valuation of Bell company payphone assets. The reasons APCC believes the Commission is mistaken are set forth in the attached excerpts from APCC's petition for reconsideration in that docket (Attachment 1) and from the brief of APCC and other payphone associations in the Court of Appeals (Attachment 2). Both these documents are hereby incorporated by reference into this petition. In essence, APCC argues that, notwithstanding the Commission's existing accounting rules, the Commission must change its rules to the extent necessary to carry out the Congressional intent for Bell company payphone operations to be transferred at an appropriate valuation to unregulated books. Even if the Commission believes that its existing cost allocation rules are otherwise adequate and appropriate for Bell company payphone operations, it has no discretion to deviate from the accounting treatment that Congress clearly intended.

Because the Commission's Payphone Order referenced this proceeding in discussing why the Commission would not change its accounting rules to implement a transfer of Bell company payphone operations at fair market value to unregulated books, APCC is requesting the Commission to reconsider its Report and Order in this proceeding, and to modify its rules to the extent necessary to require the Bell companies to place their payphone operations in separate, unregulated books of account. APCC also requests the Commission to require an exogenous cost change to address the transfer of payphone assets to unregulated books at fair market value. 47 CFR § 61.45(d)(vi).

Requiring the Bell companies to place their payphone operations in unregulated books of account would not require any major change in the Commission's accounting rules. As noted in APCC's initial comments in this proceeding, the primary booked assets of a Bell company's payphone operation are the payphone equipment and associated enclosures, and these assets are being classified as entirely nonregulated. APCC Comments at 9. See also Attachment 3 (excerpts from Bell companies' CAM Manual revisions; showing that payphone equipment assets are assigned entirely to nonregulated activities). Further, to the extent that payphone operations utilize network facilities, the costs of the associated network activities are not allocated to the nonregulated side. Instead, the services are required to be provided by the regulated side on a tariffed basis. Payphone Orders, ¶¶ 146, 159. Thus, sharing of network assets and resources is, or should be, non-existent. Other sharing is minimal. APCC Comments at 9-10. The Commission's rules already provide for "separate books" accounting treatment of nonregulated activities that do not involve the joint or common use of assets and resources in the provision of both regulated and nonregulated products and services. 47 CFR § 32.23(b). Therefore, at most, the Commission need only modify Section 32.23(b) of its rules to provide for "separate books" accounting treatment of the Bell companies' nonregulated payphone operations, whether or not there may be some minor sharing of assets and resources between payphone operations and regulated operations.

CONCLUSION

The Commission should reconsider and modify its accounting rules as applicable to payphone services, as discussed in the foregoing petition.

February 20, 1997

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ATTACHMENT 1

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996	)	CC Docket No. 96-128

PETITION OF APCC
FOR PARTIAL RECONSIDERATION AND CLARIFICATION

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proximity of another payphone is ample proof that the location in question is not one where payphones cannot be profitably maintained.[5]

IV. THE COMMISSION'S RULING ON VALUATION OF LEC PAYPHONE ASSETS IS CONTRARY TO LAW AND POLICY

APCC requests reconsideration of the Commission's decision on valuation of the LECs' deregulated payphone operations. Order, ¶¶ 161-71. Section 276(b)(1)(B) requires the Commission to discontinue the access charge elements and all other payphone subsidies from basic exchange and exchange access revenues. The Conference Report expressly states that to implement this requirement:

> [t]he payphone operations will be transferred, at an appropriate valuation, from the regulated accounts associated with local exchange services, to the BOC's unregulated books.

Conference Report at 158. For the reasons stated below, the Commission improperly failed to adhere to this clear indication of Congressional intent when it chose to value the LECs' payphone operations at the net book value of the physical assets, rather than the actual economic value of the payphone business as a "going concern."

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5 The Conference Report specifically noted that "the term [public payphone] doe not apply to a payphone located near other payphones. . . ." Jt. Statemenet of Managers, S. Conf. Rep. No. 230, 104th Cong., 2d Sess. 159 (1996) ("Conference Report ").

A. The "Going Concern" Valuation Of LEC Payphone Operations Far Exceeds Their Net Book Value

The record evidence showed, and it is undisputed, that the actual economic value of those "payphone operations," which properly should include the value of intangibles such as payphone location contracts and goodwill, is likely to be far in excess of net book value, which is the valuation advocated by the BOCs Bell companies and adopted by the Commission. Thus, valuation at net book value would not come even close to ensuring that ratepayers are repaid for the actual economic value of RBOC payphone operations.[6]

In the payphone context, the value of payphone assets is enhanced by the payphone provider's selection of the locations where payphones are installed, as well as by the contracts between the LECs and location providers. See Reply Comments of the Georgia Public Communications Association ("GPCA') at 13-14.

These value enhancements are reflected in the prices that have been paid when payphone businesses are sold. In GPCA's Comments in this proceeding, GPCA provided a study by NuCom, an IPP provider, which reviewed per-pay phone prices paid in recent acquisitions of IPP providers. GPCA Comments at 17 and Attachment 1. The average per

6 It is not just the payphone equipment that is being transferred. The equipment will remain at the existing locations pursuant to contracts and relationships established at ratepayers' expense. Unless the contracts are rescinded in order to give location providers a "fresh look," the location contracts are also being effectively reclassified or transferred, and the RBOCs' shareholders, not their ratepayers, will reap all the benefits of those contracts as well as associated goodwill. In addition to location contracts, the value of LEC payphone assets also is enhanced by the goodwill that has resulted from the investment of ratepayer money in maintaining payphones at a location. The RBOCs have admitted (RBOC Coalition Comments at 16) that ratepayers for other RBOC services have subsidized the RBOCs' payphone operations, which include commission payments and other services intended to enhance location provider satisfaction with RBOCs' payphones.

payphone price was approximately $3,200, which at a minimum can be used as a benchmark for beginning to review transfer valuation methods. Id. Likewise, in the Reply Comments of Communications Central Inc. ("CCI"), CCI showed that it allocated over 65% of payphone business acquisition purchase prices to intangibles such as location contracts. CCI Reply comments at 15-16 and Attachment B. These benchmarks demonstrate that the economic value of payphone assets is enhanced by intangibles such as goodwill and location contracts, and that net book value would be a totally inadequate measure of economic value.

Finally, in GPCA's Reply Comments, GPCA showed that U S West offered to pay $1,600 per site to acquire a bankrupt IPP provider's payphone business, and U S West sought to acquire only the IPP provider's location contracts and good will -- U S West did not even want any of the physical equipment. GPCA's Reply Comments at 14 and Attachment 3. This example is overwhelming proof that net book value does not capture the value of pay telephone assets transferred out of regulation.

B. The Commission's Refusal To Require A Determination Of Actual Economic Value Is Contrary To Law

The Commission's Order itself acknowledges that the value of the intangibles discussed above is properly included in the fair market value of the Bell Companies' payphone assets and would be credited to ratepayers if the payphones were transferred to a separate affiliate. Order, ¶ 164. However, the Commission decided that ratepayers are not entitled to that credit when a LEC's deregulated payphone operations are retained in the same corporate entity with regulated services. The Commission concluded that its existing accounting rules require that fair market value not be considered when assets are retained in the same corporate entity. In those circumstances, the payphone assets are merely being "reallocated," and the Commission found that its existing accounting rules require that reallocated assets be booked at net book value, regardless of their actual economic value. Rather than alter its accounting rules to carry out the Congressional intent, the Commission concluded that the Conference Report could not have meant what it said when it stated that the RBOC payphone operations would be "transferred, at an appropriate valuation, . . . to the BOC's unregulated books."

This portion of the Commission's Order is contrary to both law and policy and must be reconsidered. The Commission is not authorized to adhere to its existing rules regardless of the statutory command. Rather, the Commission is required to adhere to the unambiguous Congressional intent. Chevron U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 842 (1984).

1. The Committee Report Unambiguously Expresses Congressional Intent that Payphone Operations be Transferred, at an Appropriate Valuation, to Unregulated Books

The committee report made clear that the payphone operations were to be "transferred, at an appropriate valuation," from the Bell companies' regulated accounts to their "unregulated books." This statement plainly directs the Commission to do several things, none of which the Commission has done. First, Congress intended that the assets be "transferred . . . to . . . unregulated books," not reallocated. The Commission has expressly denied that there is any transfer, and the accounting treatment it has required leaves the Bell Companies' operations on the regulated books, not the unregulated books. Second, Congress intended that there be "an appropriate valuation," not a blind reshuffling of numbers in books of accounts. By treating the change as a mere reallocation of assets, the Commission has precluded any "appropriate valuation" of the transferred payphone operations. Third, Congress intended that the entire Bell company "payphone operations" are to be valued and transferred, not just the physical equipment. The treatment dictated by the Commission assigns no value to anything other than the physical assets.

2. The Committee Report Language is Fully Consistent with the Statutory Language

The Commission seems to be reluctant to do anything that is inconsistent with its existing accounting rules. However, this is a rulemaking. It is axiomatic that in a rulemaking, the Commission can change existing rules to the extent necessary to carry out its purposes. Indeed, the Commission acknowledges that Section 276 gives it the authority to change its accounting rules. Order, ¶ 162. Further, this is a rulemaking specifically directed by Congress to carry out a restructuring of the payphone industry. There would be no need for such a rulemaking if Congress had simply desired the Commission to apply existing rules.

The Commission reasons, however, that, to the extent that carrying out the committee report's statement of intent would require a change in the Commission's accounting rules, the Commission may disregard that statement because it is inconsistent with the language of the statute.

The Commission makes two arguments to support this claim. First, the Commission notes that Congress chose not to require that payphone operations be transferred to a separate subsidiary. The Commission reasons that "if Congress intended that there be a "transfer", we believe that Congress would have required . . . separate affiliates . . . ." Order,

¶ 170. This argument is simply fallacious. It is entirely consistent for Congress to intend that payphone operations remain in the same corporate entity with regulated exchange operations, while requiring that they be transferred to separate books of account. The Commission itself mandated such treatment when it deregulated customer premises equipment ("CPE") of non-Bell LECs. Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second computer Inquiry), Fifth Report and Order, FCC 84-547, 49 Fed. Reg. 46378 (Nov. 26, 1984) ("CPE Detariffing, 5th Report and Order"). Indeed, elsewhere in the Order the Commission recognizes that the appropriate implementation of Section 276 is to reclassify payphones as CPE; it is entirely logical that Congress intended to require the transfer of payphone operations to unregulated books.

The Commission's second argument is that transfer to unregulated books would be inconsistent with the statutory requirement that it adopt nonstructural safeguards that are, at a minimum, equal to those adopted in Computer III. The Commission reasons that since its current cost accounting rules, based on cost allocation, are part of the "nonstructural safeguards" of Computer III, exclusion of those cost allocation rules would be contrary to the Congressional intent that they be included. Id. This argument too, is fallacious. For example, when AT&T and the Bell companies were subject to structural separation requirements, with separate books, they nevertheless allocated the cost of services shared between the nonregulated subsidiaries and the regulated telephone service company.[7] Conversely, as

[7] See e.g., General Departments Order, 90 FCC 2d 184 (1981); Shared Services Order, 92 FCC 2d 676 (1982), recon. denied, FCC 83-355 (released July 29, 1983); American Information Technologies Inc., et al., Capitalization Plans for the Furnishing of Customer Premises Equipment and Enhanced Services, FCC 85-28, File Nos. 84-(25-31), released Feb. 4, 1985, aff'd NATA v. FCC, 772 F.2d 1282 (7th Cir. 1985).

mentioned above, when the Commission deregulated independent LECs' CPE without subjecting them to separate subsidiary requirements, it nonetheless required the LECs to transfer the CPE to nonregulated books. Under the rules established by that order, cost allocations could be and were performed to allocate joint and common costs between regulated service and nonregulated CPE activities. CPE Detariffing, 5th Report and Order. Even under the Commission's current rules, the rules expressly recognize that in some circumstances, carriers that are not subject to structural safeguards and that have not established corporate affiliates, nonetheless may be subject to "transfer/valuation" rather than "reallocation" treatment for certain intracorporate transactions. 47 CFR § 32.23(b).

Moreover, the Commission's current rules authorize and require the use of market value-related concepts to determine the proper accounting for some activities of entities subject to cost allocation. For example, a LEC must impute basic services utilized by its own nonregulated enhanced services activities at the tariffed rate for those services. 47 CFR § 64.901(b)(1).

The Commission does not need to do away with its cost allocation rules in order to carry out Congressional intent that "payphone operations. . . be transferred, at an appropriate valuation, . . . [to] unregulated books." There is no necessary inconsistency between the use of separate books and a market valuation of deregulated payphone assets, on one hand, and the application of cost allocation rules to account for investment and expenses that are shared between regulated activities and nonregulated payphone operations.

The references in the statute and committee report to Computer III as the minimum level of "nonstructural safeguards" do not authorize the Commission to disregard clear indications of Congressional intent as to the manner in which reclassification of existing payphone assets should be carried out. Computer III involved the application of a wide variety of "nonstructural safeguards," none of which are intrinsically tied to the use of a particular system of cost accounting.[8]

Furthermore, the statutory requirement to adopt nonstructural safeguards is in a separate paragraph of Section 276 from the requirement to terminate existing access charge elements and subsidies. The sentence of the committee report that states that existing payphone operations are to be "transferred to unregulated books" is clearly intended to refer to the Section 276(b)(1)(B) requirement to discontinue existing access charge elements and subsidies. The subsequent sentence of the Conference Report, which discusses nonstructural safeguards and the Computer III minimum, obviously references Section 276(b)(1)(C), which discusses those same nonstructural safeguards and Computer III minimum. Thus, the two sentences of the Conference Report refer to separate provisions of Section 276, and should not be read together so as to result in one contradicting the other, as the Commission's Order has done.

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[8] Moreover, Computer III (unlike Computer II) did not involve any major reclassification of existing assets from regulated to nonregulated status. There were no assets transferred in Computer III. Unlike payphone equipment, which has been regulated for years and now is being transferred to nonregulated status, the enhanced services at issue in Computer III had not been provided at all by the LECs, and therefore did not involve any substantial amount of regulated assets that had to be converted to nonregulated status. Thus, there is no reason to believe that the references to Computer III were intended to change the expressed Congressional intent regarding valuation of existing payphone assets.

In summary, the unambiguous Congressional intent is for the Bell companies' payphone operations to be transferred, at an appropriate valuation, from regulated accounts to unregulated books. A clear statement of Congressional intent cannot be overridden unless it is in direct conflict with the plain meaning of statutory language. Here, it is clearly possible to read the statute as consistent with relevant indicia of intent, and the Commission therefore must do so.

C. Policy

In addition to being contrary to unambiguous Congressional intent, the Commission's decision on valuation is contrary to sound public policy and the Congressional command to eliminate all payphone subsidies.

1. Ratepayer Effects

As mentioned above, the Commission's Order recognizes that going concern valuation, including valuation of intangibles, is the appropriate method of ensuring that ratepayers are appropriately credited for affiliate transactions. That was the method recognized by the Commission in Computer II, where net book value was used as a surrogate for economic value only because, in the circumstances then present, the Commission concluded that (1) net book value was a reasonable proxy, (2) appraisal of economic value was impractical, and (3) ratepayers were protected by being given the option to buy their CPE at net book value. Here, none of these conditions are present. Thus, there is every reason to require a transfer at appraised economic value in order to ensure that ratepayers receive the full value of the sums they have invested in regulated payphone equipment that is now being deregulated at a substantial gain over net book value.

Even assuming that the Commission were free to disregard Congressional intent, there are no persuasive policy reasons why the transfer of payphone assets should be valued at net book value instead of actual economic value. The Commission states that its cost allocation rules are fully adequate to protect ratepayers from subsidizing LEC payphone operations. However, the Commission cannot point to any justification other than the alleged need for consistency with existing rules, that would explain why valuation of payphone assets at true economic value, which concededly is the appropriate and necessary result if the payphone operations are transferred to a nonregulated separate subsidiary, is not also the appropriate and necessary result when the payphone operations are transferred to a nonregulated payphone division.

This is not a situation where allocation of assets (such as network facilities) between regulated and nonregulated activities is likely to change over time, so that accounting convenience and business efficiency might be served by leaving the entire pool of assets in one set of accounts and allowing the carrier to periodically reallocate the assets without having to recreate an economic transaction each time. The assets in question are payphone equipment and enclosures[9] -- discrete items that are placed on customer premises and that are easy to identify and separate from other types of investment such as network facilities.[10] These assets

9 In addition, as discussed above, there are related intangible assets such as contracts for the location of such payphone equipment and enclosures, and related goodwill.

10 The Commission recognized the severability of payphone operations from network (Footnote continued)

have been declared 100% permanently nonregulated, as a matter of law. Barring some extraordinary reversal of policy, no portion of these assets is ever going to be "reallocated" back to the regulated side. Therefore, there is no reasonable basis for concluding that retaining these assets in regulated accounts, and depriving ratepayers of compensation for their true economic value that is likely to be far in excess of net book value,[11] will provide any significant protection for ratepayers. [12]

(Footnote continued)
facilities when it ruled that: "payphone assets to be reclassified or transferred [do not include] the loops connecting the payphones to the network, the central office "coin-service," or operator service facilities supporting incumbent LEC payphones. . . . " Order, ¶ 159.

11 Contrary to the Bell companies' claim, the gains resulting from a valuation at actual economic value at the time of the reclassification/transfer to nonregulated books could and should be recognized under the Commission's price cap rules as an exogenous cost adjustment "triggered by administrative, legislative or judicial action beyond the control of the carriers." Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6807(1990). Such exogenous cost adjustments include, among other things, "[t]he reallocation of investment from regulated to nonregulated activities pursuant to § 64.901; [and] [s]uch tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require . . . ." 47 CFR § 61.45(d)(1)(v), (vi). From the perspective of the purposes of the exogenous cost rules, the transfer of LEC payphone operations from regulated accounts to nonregulated books is the same sort of exogenous change as the "reallocation of investment from regulated to nonregulated activities," and is clearly the type of "extraordinary exogenous cost change" that the Commission intends should be covered by the exogenous cost adjustment rule.

12 The Commission's belief that ratepayers are adequately protected by a net-book-value cost allocation is further undercut by the statement that "exepnses incurred during the period payphones were regulated remain as regulated expenses. . . ." Order, ¶ 159. The Commission's approach thus precludes protection of ratepayers even from the use of ratepayer money to pay substantial up-front bonuses by LECs to secure profitable locations just prior to deregulation -- an acknowledged industry practice and instances of which are documented in the comments filed by the Inmate Calling Services Providers Coalition.

Further, the Commission acknowledges that the increment of economic value over net book value should be credited to ratepayers if the payphone division were actually being sold out of regulation to an unaffiliated buyer (as at least one Bell company has been attempting to do) or even to a BOC affiliate. The Commission states that under its accounting rules, when deregulated assets remain on the regulated books, "any resulting gains from a sale of those nonregulated assets accrue to the carrier and to the benefit of ratepayers and shareholders." Order, ¶ 165.[13]

Assuming that this statement correctly describes the legal effect of a sale of assets that have already been reclassified as nonregulated, then the valuation mandated by the Order would still be against public policy because it would substantially remove any incentive of the Bell companies to sell their payphone operations, even at a profit. Since any profit would have to be credited back to ratepayers, the Bell companies would be incented to hold onto their payphone operations as long as possible.

The Commission's decision on the valuation of LEC payphones creates perverse incentives and does not serve the public interest. The Commission's decision that the economic value of the payphone assets will only be recognized if a LEC 'transfers' its payphone operations to a separate affiliate creates a significant disincentive for LECs to choose this

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13 However, the Commission does not explain which of its accounting rules would determine the treatment of such a sale, or how any ratepayer credits resulting from such a sale would actually be implemented to benefit ratepayers under the Commission's price cap rules. For all that appears, application of cost allocation rules to the deregulation of payphone assets will preclude the value of intangibles from ever being credited to ratepayers. No rule is cited that would prevent a Bell company from selling its payphone operations and sharing none of the intangible value with ratepayers.

option as the means by which they will operate their nonregulated payphone operations. Even if this were the preferred and most economic choice of a LEC, the Commission's decision effectively prohibits a LEC from choosing this option. Barring extreme circumstances, no rational LEC would elect to operate its nonregulated payphone operations through a separate affiliate if it knows a priori that by so doing, it will lose its ability to ensure that the value of intangibles will accrue to the benefit of stockholders instead of ratepayers. Thus, while the Commission concluded that "the BOCs or other incumbent LECs are free to provide these services using structurally separate affiliates if they choose to do so" (Order, ¶ 157), the Commission's decision effectively precludes such a choice.

But there is no overriding public policy reason to incent the LECs to opt for the provision of their payphone operations through nonstructural separation. While, in some cases, nonstructural separation might be argued to serve the public interest by spreading some of the common costs to a LEC's nonregulated operations, in the case of payphones, the share of common costs that would be allocated to the nonregulated payphone operations is likely to be very small for the reasons discussed above. These supposed savings would most likely be swamped by the gain that ratepayers would realize if the payphone operations were transferred at fair market value to the nonregulated books of the LEC.

The Commission states that it "believes regulated ratepayers are better served by the requirement that carriers account for payphone operations in regulated accounts than if [it] required them to account for payphone operations in 'nonregulated' accounts or 'unregulated books'." Order, ¶ 171. The Commission does not provide any support for such a finding. In fact, just the opposite is true. Regulated ratepayers would be better served if the gain associated with the true economic value of the payphone operations was transferred to ratepayers now -- not at some unknown, if ever, time in the future. Moreover, since the Commission's decision creates such perverse incentives that LECs may never sell their payphone operations or transfer them to an affiliate, ratepayers may never realize or be compensated for the enhanced value of the payphone operations which they supported and subsidized while regulated.

The Commission's conclusion that it could at some time in the future capture any gain if a LEC should sell its payphone operations is flawed not only for the reasons previously discussed but for an additional reason. To the extent that the value of the payphone operations has been enhanced after deregulation, due to the superior management of the LECs, this enhanced value should belong to stockholders, not ratepayers. However, if the Commission waits until some time in the future, i.e., when the assets are sold or transferred to an affiliate, it will be extremely difficult to determine what portion of the gain should belong to ratepayers and what portion should belong to stockholders. If the Commission were to assign all of the gain to ratepayers, then ratepayers would be rewarded for an investment which they did not make. Rather than engage in the guesswork that would be required at some time in the future, the Commission should settle this matter now. Ratepayers will receive their fair share of any gain today and in the future, stockholders will receive their fair share of any gain.

The Commission can remove these perverse incentives and at the same time reward ratepayers for subsidizing the payphone operations while they were regulated and reward

LEC's stockholders if they sell their payphone operations in the future. By requiring that the LEC payphone operations be either transferred to the LEC's nonregulated books at their fair market value, including the intangible assets and goodwill, the Commission can remove the perverse incentives discussed above. Under this arrangement, a LEC would be indifferent between either structural or nonstructural operation of its nonregulated payphone operations. The decision would be based on sound economic and business principles, as it should be, not on a regulatory decision that provides perverse incentives. Furthermore, regulated ratepayers would receive the benefits of any gains realized from these transfers today as they should be valued -- not at some unknown time in the future when assignment of any gain will be pure guesswork. After the assets have been properly valued and transferred, any appreciation in the value of the assets in the future should remain with the nonregulated operations, and any profits or gains from the sale of these assets should accrue to the benefit of stockholders.

2. Competitive Effects

In addition to the impact on ratepayers for regulated services, there can be little question that undervaluation of payphone assets would have a distorting effect on the payphone marketplace. If net book value is, for example, only 50% of economic value, then the LEC would begin nonregulated operation by effectively being given half of its payphone base "for free." It is not credible to find that such a large and unwarranted economic windfall would have no effect on the behavior of the dominant payphone competitors.[14]

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[14] It is clear that the RBOCs believe that the Commission's decision on valuation of their payphone assets will have an economic effect. If the RBOCs did not believe they would be affected, they would not have directed their attorneys to submit a 13-page single-spaced legal memorandum opposing "going concern" valuation.

There may be a theoretical argument that LECs' market behavior would not be affected by undervaluation of their payphone assets. However, this argument flies in the face of reality. It is simply not credible that LECs and their shareholders would be unaffected by incorrect asset valuation that affect the assets and liabilities carried on the nonregulated accounts of their payphone operations. Such valuations would, at a minimum, affect the perceptions of LEC shareholders and bondholders, if not LEC managers as well, about the profitability of the LEC payphone operations. Clearly, this would lead to distortive behavior, such as overinvestment by providers of capital in LEC payphone operations, as compared to investment in the non-LEC PSPs.

At a minimum, to the extent that LEC shareholders are misinformed about the actual profitability of their payphone businesses, they will be unable to correctly evaluate management decisions. Marginally profitable payphone operations may be mistakenly viewed as highly profitable, while unprofitable operations may be mistakenly seen as competitive. Such distorted perceptions would, at a minimum, cause major inefficiencies by encouraging an inefficient competitor to remain in the market or encouraging a marginally efficient competitor to expand. Moreover, to the extent that the LECs have an incentive to maximize long-run profits by conducting predatory activity in the payphone market, they will have far more freedom to engage in such activity if they are able to avoid repaying ratepayers for the full value of their deregulated assets.

In summary, the Commission's refusal to require a valuation of deregulated LEC payphone operations at their true economic value is contrary to law and policy and must be reconsidered.[15]

Dated: October 21, 1996

Respectfully submitted,

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15 The Commission's Order does not preclude the states from requiring ratepayers to be credited for the true economic value of the reclassified payphone operations.